Notes for Meeting of April 4, 2000
Market Mechanisms for Student Loans
(Student Loan Study Group 2--Section 801 Study)

Attendees

Maureen McLaughlin	Department of Education
Vic Rezendes	General Accounting Office
Bob Scott	Ramapo College of New Jersey
Tony Dolanski	Sallie Mae, Inc.
Bill Beckmann	Student Loan Corporation
Claire Mezzanotte	Fitch IBCA, Inc.
Jamie Pueschel	U.S. Students Association (for Kendra Fox-Davis)
Gail Norris	Utah Higher Education Assistance Authority
Pat Smith	American Association of State Colleges and Universities
Ivan Frishberg	U.S. Public Interest Research Group
Paul Wozniak	Paine Webber Incorporated
Terry Muilenburg	USA Group (for Jim Lintzenich)
Paul Tone	UNIPAC
Scott Miller	Pennsylvania Higher Education Assistance Agency (for Michael Hershock)
Dick George	Great Lakes Higher Education Corporation
Mary Bushman	AFSA Data Corporation
Harrison Wadsworth	(for Dick Pierce, Maine Education Services)
Bruce Johnstone	SUNY Buffalo
Kathy Cannon	Bank of America
Laurie Wolf	Des Moines Area Community College
Judy Case	University of Massachusetts Medical School
Susan Pugh	Indiana University
Deborah Mott	Ferris, Baker Watts
David Mohning	Vanderbilt University
Robert Cumby	Department of the Treasury
Nabeel Alsalam	Congressional Budget Office
Wayne Upshaw	Office of Management and Budget

Other government staff:

Department of Education	David Bergeron, Daniel Pollard
General Accounting Office	Barbara Bovbjerg, Jay Eglin, Jim Spaulding, Mitch Rachlis, Kopp Michelotti, Gene Kuehneman, Susan Chin
Department of the Treasury	Susan Lepper
Office of Management and Budget	Lorenzo Rasetti

Opening remarks

Vic welcomed the group and outlined plans for the meeting. Maureen summarized the last meeting and noted that GAO and Department of Education want to get as many options on the table as possible at this point then focus on a few to be analyzed in depth. In particular, they wanted to find out about international models.

International models

Bruce Johnstone gave a presentation about research he has in progress concerning higher education financing in other countries (see presentation and notes). He discussed these programs in the context of two sometimes conflicting major goals of many national student loan programs in recent years: (1) shifting costs of higher education from the government and taxpayers to parents and students, and (2) increasing accessibility to higher education.

Bruce explained that the United Kingdom's plan involved no banks, that it was all public lending, that grants were being phased out, and that income contingent repayment was a feature of the program. Bill Beckmann said that the program had a 28% subsidy rate and Claire Mezzanotte noted that the program has changed recently.

Bruce also discussed several other countries' programs. Australia's HECS program included transmission of loan proceeds directly to the university, not to borrowers; income contingent repayment; a 0% real interest rate; a progressive "income surtax;" and collections through the tax office. Whether because of collections through the tax office or the income-contingent repayment aspect, the program appears to be successful in collecting borrower repayments and has apparently received broad popular support because repayment is "painless"--"you don't feel like a borrower."

Sweden has a long history of loans and extensive participation. Thirty percent of costs are covered by grants and 70% by loans (the ratio used to be 50-50). Income contingent repayment is allowed, with an interest rate slightly below the government's cost of borrowing and forgiveness of remaining loan balance at age 65. As with other Scandinavian countries, Sweden has a history of treating all students as independent--that is, parental income is not figured into a borrower's need. Furthermore, with no tuition charged, borrowing has been necessary only to cover living expenses. So, as with many of these countries, education policy and responsibilities for costs in Sweden are very different from those in the U.S.

China has new loan programs operating in eight cities. The "regular" program requires co-signers and collateral. Under the "special" program, the risk is shared by the bank (40%) and the university (60%). The rate paid by students is half the market rate because of government subsidies. Problems with the setup have resulted in very little loan activity under this program.

Bill said an important general question is what cost is borne by the students, the parents, and the governments for each program. He also described Canada's loan system, which 5 years ago began using private capital, with a bidding system to determine lenders' loss rates. Defaults, and thus losses, were higher than expected, and the program is now being restructured.

Tony Dolanski noted that U.S. higher education is very different from higher education in other countries--in the U.S. there are many choices and students pay a good part of the costs. The large implicit subsidies contained in the low in-state tuition and fees charged by state educational institutions in the U.S. may appear similar to the international models. However, the American system of higher education is quite heterogeneous and includes a relatively large proportion of private non-profit and for-profit institutions in which the government and the institution do not directly help pay for the student's tuition and fees. Bruce replied that in some respects, the international experience is relevant. In the U.S., some students at the advanced level are not paying for their education – costs are defrayed through fellowships or assistantships. Also, in many countries, students do pay, and the general trend is toward more cost-shifting to students. He gave the example of Russia, where the constitution specifies free tuition but 20% of university income comes from tuition and universities seek to "enlarge the loophole" that allows them to collect.

Dick George thought that other countries' programs were relevant in terms of transferring costs to students. Bill wondered if there were any best practices for the US to emulate. Bruce said that his research reaffirmed that student loan rates must at least be close to government borrowing rates; the problem has been over-subsidization. One example is Germany, which has no interest plus a 5-year grace period. But reducing subsidies could be at odds with loans serving as an engine of accessibility.

Bob Scott asked whether there were any differences in incentives by status of student, e.g. remedial vs. regular undergraduate vs. graduate. Bruce said there might be some lessons for the U.S. but he was not sure of the details. Researchers can get program descriptions, but it's hard to get data on participation and other operational information.

Gail Norris models

Gail Norris discussed several possible models (see handout). He said that we must be careful of introducing new complexity; complexity adds cost. In addition, it's important to decide what are the goals of student loan policies, through what process those policies will be set, what tools and information will be used, what strategy and tactics employed, and what economic policy/ideology is preferred. The incremental adjustment model is essentially a matter of tactics and in effect has been the model in use in recent years. That is, returns have gradually decreased and so far there have been no ill effects, although there are fewer lenders and there has been consolidation of guarantee agencies (from 50 in the past to 33 now). The model is volume sensitive; that is, it favors larger lenders. It would be a value judgement by the states to choose to subsidize other lenders. One of the problems with the model is that it is subject to competing analyses, and data from one participant may not be trusted by others. Under current practice, market forces have steered loan programs toward desired policy goals, and Direct Loans (DL) have made the private sector improve more rapidly.

Some data has been generated that could be useful for the cost of funds model, which addresses the tools used in the decision-making process. The blue ribbon commission model addresses how decisions are made and by whom.

Vic noted that historically commissions have been advisory. Gail said the procedures could be written to charge the commission with advising the Congress, or for the commission or some other body to make the decision. Its recommendations could be tied to the annual budget cycle, for instance. Maureen wondered whether the incremental adjustment model would use an administrative or a legislative process. Gail responded that using a panel to advise the executive branch, which would be responsible for rate setting, would help take the heat off the Congress.

Tony Dolanski models

Tony discussed some general principles and two possible models – the "FHA model" and the "classic competition" model (see notes). One goal of both approaches is to let buyers and sellers determine rates and get the Congress out of the rate-setting process. The general principles he suggested were:

1. student loans should be affordable and accessible credit for all students;
2. we should consider the role of schools--they can counsel students, they can also screen vendors;
3. we should consider the origination and guarantee process, try to simplify it--it affects costs;
4. servicing standards must be set and maintained;
5. there should be vigorous competition--results may be hard to predict upfront but could include new participants;
6. the industry should develop new technologies and creative approaches;
7. there should be disclosure;
8. there should be stability; through good and bad economic cycles, lenders must be there;
9. subsidies should be segregated; subsidies should go to students; separate subsidy issues from market issues; the marketplace can set prices properly but only the political system can decide subsidy issues.

In the FHA model, FHA provides a 100% guarantee, lenders are approved by FHA (there are about 8,000 of them), and loan size and credit criteria are specified. Lenders administer the guarantee, lenders and borrowers negotiate rates, and rates may differ for different borrowers by no more than 2 percentage points on a given day. Factors that would be considered for student loans are size of loan (smaller are more costly to service), default rates at different schools, the 2% risk and the cost to get the loan on the books. It was noted that GNMA securitizes about 95% of FHA loans, there is audit oversight of servicing standards, and there is a wide variety of lenders. In 1984 the FHA program changed from government-set interest rates to market rates. Currently, the difference between conventional and FHA rates is small (of course, the house is there as collateral for these loans).

Dick asked what would happen if students borrowed several times. Tony replied he thought multiple loans should work as they do today. Dick said he didn't think it worked well today, that schools mediate between students and lenders, often based on lenders' discounts. Tony stated that future loans could be part of the initial contract to avoid split servicing. Dick also thought that students would be unsophisticated borrowers. Bill Beckmann said that was no different from today's situation. Bill also wondered how subsidy decisions would be made. Tony thought that ideally there should be no rules with respect to lenders and borrowers negotiating. Other aspects of student loans, such as subsidies, would be decided through the political process.

Bob Cumby commented that this could result in a model in which the government sets a borrower rate and the market process affects only the lender yield. Tony said that some students could get in-school interest subsidies, and lenders would bill the government. If there were a rate cap, when the cap came into play, the lender would also look to the government. Bob was concerned that loans might be structured so that a cap would come into play and perhaps open ended government payments would be called for. Tony said that the caps could be decided on periodically, e.g., each year or every 5 years.

Susan Pugh asked about schools negotiating on behalf of students. Tony replied that that happens now. Susan stated that some schools do a better job than others. Tony thought disclosure would improve the negotiating position of borrowers. One particularly powerful piece of information would be to make lenders tell what their best rate is anywhere in the U.S. Those getting less favorable rates would press hard for better rates.

Joe Flader asked what agency would take the FHA role. Tony said it could be Department of Education. Education could contract out the functions or could work directly with lenders. He noted that FHA claims are settled after foreclosure. Regarding securitization, Tony thought that the process would result in loans that would be good candidates for securitization. Mitch Rachlis pointed out that under the FHA program, FHA guarantees the loan and GNMA securitizes the loans and guarantees the securities; it's this combination of guarantees that makes the loans attractive for lenders.

Susan Lepper asked whether there would be a lender of last resort (LLR). Tony thought there should be one; he prefers that Education arrange LLR provisions with several lenders for a particular time period and a specified volume of loans. This would head off access concerns.

Bob Cumby asked about variations across the market. Tony thought there would be a narrow range for any one lender but that data should be available across all lenders. Jamie Pueschel asked about the 2-percentage-point potential variation in rates: would a lender be able to change the range from one day to the next? Tony said that lenders would have to justify any changes. Pat Smith asked about variations by income of students. Tony was not sure about the best way to handle this. Bill said that lenders would have particular criteria, underwriting standards, and that if they were unrealistic some other lender would undercut the first lender's price. Moreover, with a guarantee, most differences disappear.

Jamie asked whether new students would be "punished" because of a school's prior problems with student loans. Tony felt that the marketplace would recognize risk differences, schools' default rates would differ, and when defaults improve loan rates would improve. Beyond that, it would be a question of subsidizing students at some schools below the market-determined rate.

Claire Mezzanotte wondered whether having parents as cosigners would be a possibility. Tony said that this happens now with alternative loans, and that different students get different rates in alternative loan programs. Bruce discussed risk rating, noting that if student loan programs use credit checks and co-signers, different rates would result. To get rates into a narrow range, a full guarantee is necessary. Tony said lenders make rational decisions. A 98% guarantee ameliorates widely differing rates but a 90% guarantee would be a problem for lenders and a lender of last resort would be needed to effect some loans.

Bill said that any market mechanism will lead to variation; we have to deal with this and distinguish between economic optimization and social optimization. Dick said that alternative loan programs have created significant differentiation.

Mary Bushman model

Mary Bushman outlined a model she worked on as part of a group of people, based on retail competition in originating loans with focused subsidies based on post-graduation circumstances (see notes). Questions to be answered include who should set subsidies and how should they be distributed. Ability to pay would be determined after school, not while students are in school. There would be no government-specified origination fees, but schools could buy down the rate for their students. All subsidies would be at the back end and all subsidies would go to the borrower. There would be a guarantee at 100% or some other high level. For income-contingent repayment, some linkage to the IRS would be necessary; one option would be for the government to buy loans in income-contingent repayment from the lender at par value. Bruce said it appears this model would not have a mutual insurance aspect, where well-off borrowers actually pay more to subsidize borrowers who are not well-off. Mary indicated that some students would not want ICR because they would have to pay off their loans faster. Gail thought that we could not totally separate the subsidy from the market mechanism.

Jamie and Bob Cumby asked how a subsidy would work if a loan did not go into ICR. Mary replied that one alternative could be that there still could be some in-school subsidy determined by family income, along with the post-school subsidy determined by borrower earnings. But currently, students staying in school the longest get the highest subsidies, and they're the ones who can best afford to repay loans and least need the subsidy anyway. Susan Lepper wondered if based on market forces, students at some schools would get better rates than students at others and whether the in school subsidy would mask these differentials. If so, there would be no incentive for students to shop around. Tony thought that if subsidies were reset periodically, students would have an incentive to shop.

Tony asked whether the study group's charge was to look at market mechanisms or subsidies. Maureen stated that we would look at market mechanisms and try to gauge possible implications for subsidies. Gail thought there would be limited ability to shop around even with periodic resetting of subsidies.

Nabeel Alsalam stated that there are two kinds of subsidies: explicit—like in-school interest payments, and implicit—like guarantees or caps on borrower rates. Implicit subsidies are currently higher at riskier or less-desirable schools (where low desirability, from a lender's view, means a high default rate and/or a low average borrower balance). Without the guarantee, say, students at less-desirable schools would have more problems finding a lender at current rates than would students at more-desirable schools. In a model where borrower rates can vary, if students at different schools would get different market rates, then this would reveal that students at some schools are currently getting bigger subsidies. Bill thought that using this market mechanism would force out these subsidies. Tony thought there should be limits on the permissible range of rates allowed, coupled with full disclosure. Maureen stated that we would analyze market mechanisms to see which approaches could be used but not necessarily analyze all possible implementation details.

Nabeel felt that Mary's model could not co-exist with the DL program. If the market set a variety of rates, but DL stayed at T-bill + 1.7 / 2.3, for example, schools with higher rates would all move into DL. Tony felt we could not have a market-based system with the private sector using shareholder funds for investments in system improvements if, at the same time, there is a government loan program that is able to use tax money. Also, the government is not subject to antitrust laws. Susan Pugh thought it was difficult to talk about the roles of different people in various market mechanisms. For example, schools' negotiating role would depend on whether parts of a school--e.g., the medical school--would negotiate separately. Bill pointed out that the current model with alternative loans allows variation within a school. Bob Scott agreed with the virtue of competition and noted that the market became more competitive after the DL program started.

Joe Flader model

Joe indicated that in the study group's analyses, there should be at least one model that includes a full set of workable details. Student loan programs should provide that everyone at a school could be eligible with no family income determination, by simply signing up with a promissory note. He said that over the years there have been four concerns about the student loan program: defaults, excessive subsidies, complexity, and lack of a market mechanism to determine how much to pay non-federal participants. He discussed a proposal that highlights income contingent repayment (see notes). The proposal tries to address these concerns.

Joe stipulated several desirable characteristics of income contingent repayment plans:
1. payment should be proportionate to the amounts borrowed;
2. students should stop paying when the loan is repaid;
3. there should be a reasonable repayment schedule;
4. payments should not be a percentage of income; and
5. subsidies should be put where they are needed but not allow gaming the system by those who achieve high incomes.

Loans would have no in-school interest subsidies. This would eliminate differences between subsidized and unsubsidized loans. The model would have income contingent repayment through the IRS with payments being added to tax withholding. Tax returns would have a line for ICR payments withheld and IRS would report these amounts to the proper authorities. If payments were too small or missing the IRS would offset refunds to make up for the shortfalls. If income were under the tax-filing threshold, no loan payment would be due. The only way to default would be to not pay taxes. If loans were repaid within 12 years, there would be no subsidy. After 12 years, repayment would be made at a lower rate.

Students could choose income contingent repayment or not. Loans going into ICR would be transferred to the government, which would pay the principal and accumulated interest. Lenders could offer discounts to borrowers to keep the loans on the lenders' books. He guessed that no more than 50% of borrowers would choose ICR.

The government would auction blocks of loan authority and rank the bids to distribute the loan authority. Authority would be distributed at the next highest price. Only for-profit entities could participate in the auction; a not-for-profit organization would have to set up a for-profit subsidiary for purposes of participating in the program. Lenders could bid on several blocks using different prices. Blocks of loan authority would be salable among lenders. Lenders would not be precluded from discounting. Negative bids would be allowed; that is, the lender would bid a price that government would pay for the lender to make the loans. Assuming the market clears, if there are unserved students then there is unused lending authority. The system could be adjusted so that loans for different types of schools were auctioned differently. This approach separates the subsidy to borrowers from the lender's yield.

Tony asked whether there would be a choice of lenders for schools. Laurie Wolf asked whether bidders would be qualified; that is, would the service records of bidders be taken into account. Joe said that bidders could be prequalified; also, if lenders serviced loans poorly, other lenders would take the business. Deborah Mott wondered whether the proposal focused on price alone and also how bids might be affected by bidders' uncertainty of what the actual sale price would be. Joe said the sale price would be as good or better than what he bidder bid, but Deborah said that predictability/stability might be more important than getting a better price, especially when looking across an entire holding company's books. Paul Tone was concerned that lenders would not know how much authority they would get until the bidding process was over; if they wanted to buy more on the secondary market it would be too expensive. Kathy Cannon was concerned that a lender's student loan operation might fall apart if the lender lost out one year. Joe indicated that the proportion of total lending authority assigned to any one lender could be, and should be, limited. Dick asked about what time period lending authority would apply. Joe indicated that lending authority should not last more than one year and said that lenders would have to serve low-balance borrowers.

Judy Case thought that if the lending authority program had too much complexity and uncertainty, schools might decline to participate and just go with the private loan market. For instance, if a school's preferred lender runs out of lending authority, the school would have to scramble to find another lender for its students. She recalled that because of uncertainty in the HEAL program, her school left the program. Susan Pugh said her school walked away from HEAL for the same reasons. Students want to be comfortable with a lender, to have a certain level of trust. HEAL was too cumbersome and students didn't like it. Moreover, the timing of the program didn't match schools' and students' needs, e.g., lending authority year did not match schools' academic years. She felt that few of her students would get a subsidy and could simply use private loans. Student loans should foster access to higher education and choice among schools. Therefore, there should be subsidies at the front end of loans as well.

Jamie asked about how borrowers would pay in-school interest. Joe said it would be capitalized—added to the principal balance. Bill asked how coverage for "less attractive" schools would be assured. Would lenders all compete to make loans at the same top schools, and would others have to wait in line or scramble for a lender as the year began, and/or would they have to switch lenders from year to year? Joe replied that more authority than the total needed could be auctioned to assure there would be loans available to all schools. Gail asked how subsidies might differ over time and also whether credit unions and other non-profit lenders would be unfair competition—how could one distinguish between taxable and non-taxable sources of funds.

Nabeel Alsalam models

Nabeel presented two models: (1) volume procurement, to set the add-on to a reference rate on new FFELP loans, and (2) indirect lending, where government provides lenders with financing for student loans (see presentation). He discussed three approaches to fostering student access -- direct loans, indirect (government provides financing to private lenders who make loans), and guarantees. He also pointed out three parties are involved – the student, the lender, and the government, and two rates are involved – the student's interest rate and the lender's yield. Currently, the gross yield on FFELP loans is fixed, which means the net yield varies across schools/borrowers.

Both his proposals maintain choice for students and schools (by having many potential lenders) and both divide schools into various categories by type, cost factors, etc. Both also set the borrower rate by regulation rather than subjecting it to competition.

Under volume procurement, the DL program would continue with the same student terms, and a great deal of the FFEL program, such as its guarantee structure, could remain unchanged. Competition would be based on service alone. Gail asked whether lenders who bid differently would end up with different rates. Nabeel said no, all lenders would get the rate that clears the market--that is, the lowest add-on at which the sum of the desired volumes within the group exhausts the volume being allocated. Bob Cumby offered the possibility of non-competitive bids, through which lenders would agree to participate at whatever rate is set competitively. Bill asked about secondary markets. Nabeel indicated that lenders could make deals among one another.

Bill thought that under volume procurement lenders would not compete for schools and students on service, but on price. The model, by reducing subsidies, benefits the government more than students. Nabeel indicated that discounts lenders offer to promote efficiency (prompt payment discounts, electronic payment discounts) could continue but discounting of interest rates would disappear because that would have to be built into lenders' bids.

Pat Smith asked whether there would be a finite amount of loan authority and if so, what if more students than anticipated showed up needing loans. Nabeel thought that the present system has that forecasting problem and that it might continue, but that allocations could be increased for all lenders proportionately if needed. Paul Tone said that the model underestimates the difficulty of reallocating money among winning lenders to where the students are. A school's choice might be reduced to whoever has money left to lend. Nabeel indicated that the model could be structured to allow student and school choice to continue but that has a cost. Bob Cumby thought that lenders should be able to move money around without too much trouble. Judy Case thought that this model might change school-lender relationships. Susan Pugh thought that the HEAL program shortchanged lenders, there were fewer lenders, and so schools had to scramble to find loans for their students.

Susan also noted that Pell grants were underfunded; Indiana, for instance, has at times used its own funds to make up for the shortfall. Harrison Wadsworth stated that Pell grants were underestimated nationally for several years. Nabeel said that the Pell grant program did not used to be forward funded; now it is. The HEAL program was similar. Wayne Upshaw noted that the Pell grant program has a safety mechanism to deal with funding shortfalls. Susan said that schools had to wait for the Pell safety mechanism to catch up; schools used their own funds and then had to wait for reimbursement. Loan volumes are much larger and schools would have a hard time covering those needs and then waiting for reimbursement.

Tony Dolanski pointed out that government auctions are now used for FCC broadcast rights, timber, and a few other things. These are all items that do not have an enduring service component. An auction misses at least half the value of relationships. Bob Cumby asked who should pay for the added costs of an inefficient lender, the student or the government. Paul Tone thought that the lender pays in terms of lost net yield. In an auction, price becomes the predominant issue. Small lenders will not participate, neither in the auction nor even in the non-competitive process.

Nabeel's second model was indirect lending. The student rate would be set as a matter of education policy. The lender yield would be the student rate. Lenders would bid on funding to be supplied by the government at a discount from the student rate. In effect, the Treasury would be buying student loan backed asset backed securities from the lenders. Lenders would thus face no basis risk, because they'd be getting access to a source of funds with the same basis as their student loan yield.

Susan Lepper thought it would be easier to maintain school-lender relationships with this model. Lenders could use their own funds if they did not get an allocation of Treasury funding. Nabeel said that would be true as long as the student rate was not set so low that the lenders could not afford to make loans with their own funds.

Tony expressed the view that this would be at odds with the goal of reducing the national debt. Bill noted that on this model, the market mechanism sets the equivalent of a special allowance payment.

Art Hauptman models

Art Hauptman discussed a number of factors impacting student loan programs (see presentation). Longstanding problems went unaddressed because of the 1998 debate over rates and lender yields. The market mechanism study group was formed to address two questions: First, should borrower interest rates continue to be set by legislative formula or be determined by market conditions? Second, should supplemental government payments to lenders continue to be set in legislation or determined by market forces?

Some of his general precepts were:
- all borrowers should pay the same rate;
- the rate should be tied to Treasury bills (T bill + 2% eventually, with a new legislative formula establishing a single interest rate for borrowers during both in-school and repayment periods);
- lenders could be paid different rates for different types of loans;
- we should stop using total costs to determine eligibility for student loans;
- a market already exists for student loans in which the underlying value of student loans could be easily established; and
- collect data on existing transactions to calculate the market yield for student loans to set government payments to lenders.

On this last point, while the transactions are private, they involve loans with federal guarantees and federal interest supplements. So the federal government should be able to get this information. If lenders are not willing, they can choose to forgo the guarantee.

Dick George thought that collecting and analyzing loan sale data would be more difficult than auctions or simply selling DLs, because servicing conditions and market conditions vary so much. Art felt that a loan auction would be better than a rights auction but wondered why the program could not just ask how much one paid for a loan in the secondary market. Gail Norris thought it would be doable; sales prices should be known. Art argued that we should try to learn more, for example, what proportion of loans are sold?

Joe Flader asked about eliminating the difference between subsidized and unsubsidized loans. Art replied that the program could still continue to subsidize some students and not others; what is important is to keep the same interest rate for the in and out of school periods.

Paul Tone pointed out that data would be based on sales of existing loans, not financing activities to raise capital. Bill asked whether, if a loan is sold above par, that would be an indication that you could reduce the markup. Art said it would. Mitch Rachlis noted that the price paid for a loan depends on the rate at which the loan was made, current interest rates, and the buyer's efficiencies. Harrison Wadsworth wondered why anyone would make a loan if premiums were eliminated. He and Deborah Mott stated that most of this kind of information is already available today--some of it is private, but much is publicly available.

General discussion

Deborah Mott thought the group should pay more attention to the secondary market, not just the retail loan market. Also, she wondered whether students' rights were constrained because a school chooses to work with one particular lender. Ivan Frishberg said the loan program did not close off the student's right to deal with any lender; it just affected the student's ability to take advantage of the federal guarantee and subsidy. Jay Eglin said that FFEL lenders must be approved.

Deborah discussed the possibilities of e-commerce and business-to-business internet marketing to buy and sell loan portfolios. A certain volume is needed to securitize. If one shortens the duration it increases the yield. Tony Dolanski said that the secondary market provides liquidity and allows efficiency but it does not affect the bargain struck in the primary market between lender and borrower. Mitch Rachlis said that a liquid secondary market leads to lower rates in the primary market. Harrison Wadsworth agreed there were links and an active secondary market could result in borrower benefits.

Bob Cumby wondered who would operate business-to-business internet markets--for example, the Education Department? Deborah said the private sector should be able to implement the idea. There is a robust appetite for student loan paper; the private sector could help get more DLs off the government's balance sheet. In one view, banks, schools, and borrowers are on one side of the market, with Wall Street on the other side. The secondary markets are in the middle, infusing liquidity and soaking up enough loans to arrange for securitization (this may be why they sometimes pay a premium). Gail Norris wondered if there was any way to keep a particular borrower's loans in the same portfolio with the same servicer. Deborah said data were available to facilitate that.

Bill Beckmann presented the idea that there were two broad types of student loan model:
(1) the government sets conditions for student loans, but not the borrower rate, and eliminates special allowance type payments to lenders, or (2) the government sets the borrower's rate and uses market forces to set special allowance type payments. An undercurrent of the discussion is that today's method is not market-based, but he feels it is market-based and competitive. A secondary market premium does not imply that there's an excess subsidy. Some subsidies are implicit but they could be made explicit. If the price of loans is too high some lender would undercut the price. Tony Dolanski agreed but felt the reason the study group was formed was to find a way to substitute a market mechanism for politics; we need to decide how to set loan rates using the market. We can use what we have and make it better, giving schools and borrowers more responsibility. Joe Flader felt the current system is not market-based regarding setting the lender yield. He said that the Congress does not want to decide what the appropriate rate is.

Scott Miller mentioned risk tolerance, asking what is there that would answer the question of the appropriate rate. He asked how much uncertainty and instability we should deal with. He is drawn to models that are simpler; can we find a simple way to set the rate without changing the whole system?

Harrison Wadsworth suggested that the three models we study include the current system (are there ways to adjust it without destroying it?), an auction model, and a model based on Art's and Nabeel's analyses.

Deborah Mott said that with e-commerce and the internet one can collect ideas and compile and mine data easily, that real-time data are easily aggregated. Terri Muilenburg said that USA Group has just released a study of auctions and their analysis might be relevant to the study group's discussions.

The group agreed to try to arrange the next meeting for some time in July.